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SECURITIES INDUSTRY ASSOCIATION [Nov. 13, 1990 (Vol. XVI, No. 7)]

TRENDS

An Analysis of Emerging Trends in the Securities Industry

Produced by the SIA Research Department

SECURITIES INDUSTRY RECESSION ENTERS FOURTH YEAR

HIGHLIGHTS

1. Profits for all NYSE member firms through June barely broke $200 million. A few years ago, a single bond issue had to be larger than that to be considered "decent."

2. The industry's first half profit margin fell below 1%. ROE fared as poorly, below 2%. This most recent profit paucity follows a three-year earnings drought where the industry has suffered ROEs ranging from 5% to 10% and profit margins of 2% to 5%. In comparison, the U.S. manufacturing sector had a 17% ROE in the first half.

3. Third quarter results of publicly-held brokerage houses indicate industry profits for Q3 will deteriorate further to possibly half Q2's level. Only Discounters will show an upturn for Q3, thanks, in large part, to heavy commissions in July and August.

4. Commissions are down 11% this year and recent trends in NYSE volume do not portend improvement by year's end. If the trend holds, 1990 will be the second lowest year for industry commissions since 1985 (1988's $8 billion was worse).

5. For the first time since the 1970s, total industry revenue will not set a new record high. First half results project a 7% decrease in revenue from 1989's $59.5 billion.

6. Compensation costs are running a modest 2% below last year's level, based on first half results annualized. For most of the industry, the progress in reducing compensation costs is actually much better than 2%.

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Introduction — Industry Enters Fourth Year of Recession

The Iraq-Kuwait situation has exacerbated the fear that the U.S. economy is teetering on the brink of recession. News accounts proliferate on how surging oil prices, inflation, unemployment, etc. are about to spike our economy into a widening ditch. While the overall economy may be approaching the precipice, the securities industry slipped over the edge in 1987. Three years ago last month, the securities industry (but not the stock market) embarked on its longest down cycle since the early Seventies. Thus, as the economy teeters as we enter the fourth year of our own little recession, the brokerage industry, anything but counter-cyclical, had better be as prepared as our desert commandos to dig in for the duration.

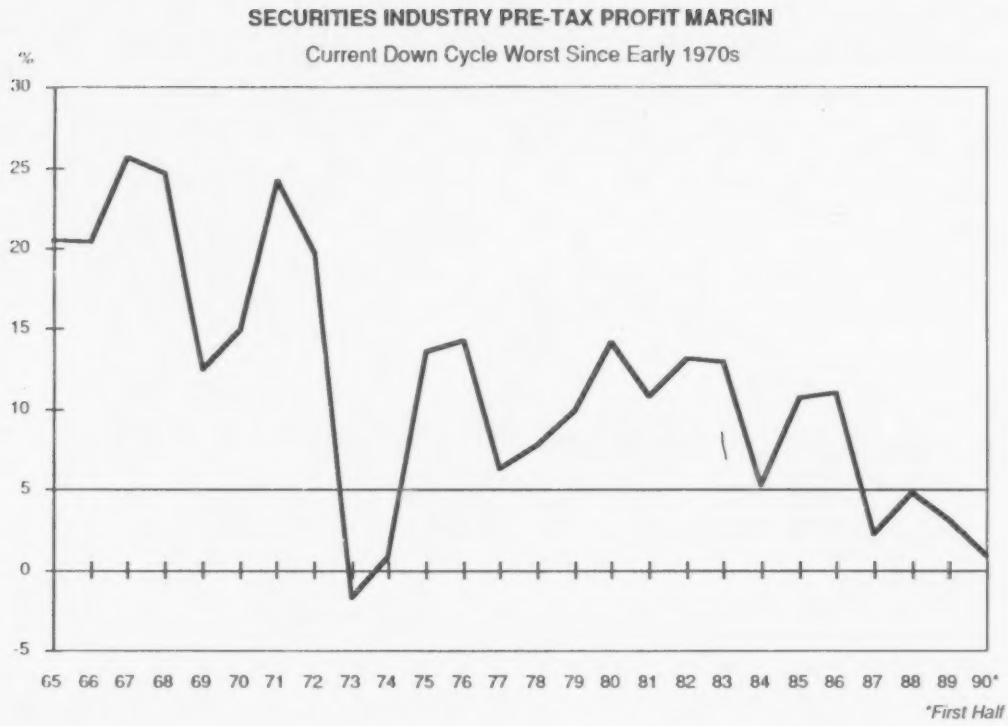
With that bearish beginning, the data on first half performance of the securities industry merely confirms the negative news. Pre-tax profits for all NYSE member broker-dealers through June barely broke $200 million. A few years ago a single bond issue had to be larger than that to be considered "decent."

Declining Profitability

The industry's first half pre-tax profit margin was below 1%. Pre-tax return-on-equity (ROE) fared as poorly, below 2%.. In comparison, the U.S. manufacturing sector had a 17% ROE in the first half. This most recent profit paucity follows a three-year earnings drought where the industry has suffered ROEs ranging from 5% to 10% and profit margins of 2% to 5% (Exhibit 1). It's painfully plain that the Nineties have begun on a very tough footing.

About the only good news this year is that the second quarter's $700 million pre-tax profit reversed the first quarter's loss of $500 million and last year's fourth quarter loss of $100 million. The reversal was mainly due to the absence of non-recurring losses, $191 million in 89:Q4 and $259 million in 90:Q1, write-offs incurred from downsizing at a few National Full Line firms. Also, the number of NYSE member firms posting red ink in the second quarter dropped to about 35% from 41% in Q1 and from 45% in last year's final quarter (Exhibit 2). But with from one-third to one-half of all members still posting losses each quarter since the crash, this is hardly encouraging.

Exhibit 1

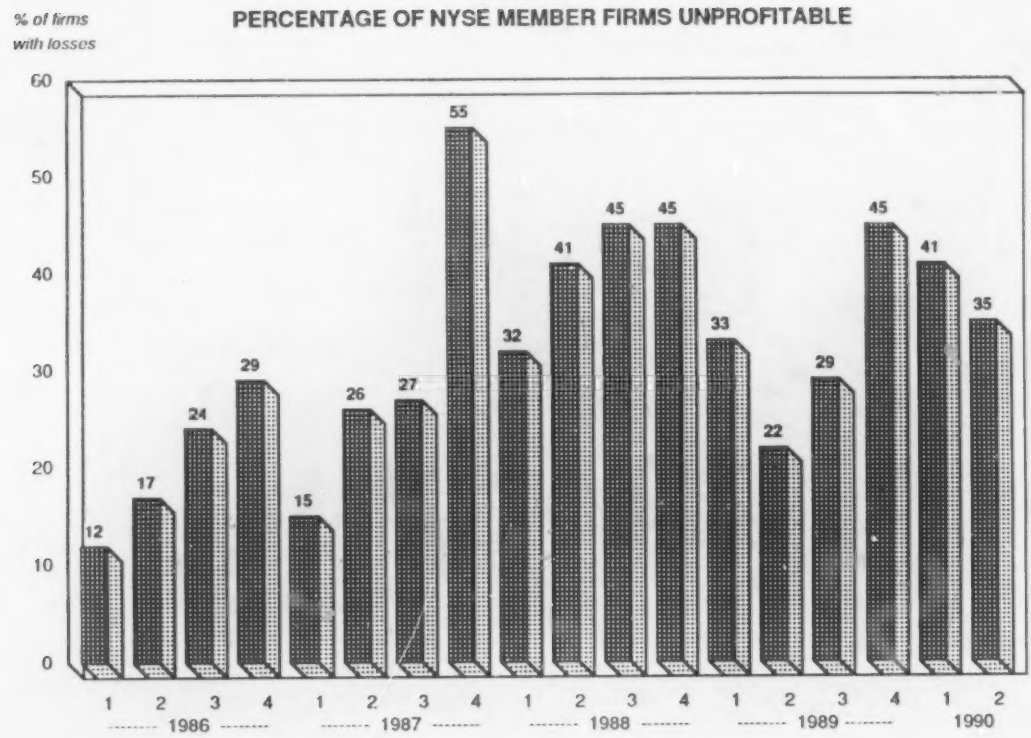


Third Quarter Results To Head Further South

Further, the Q3 results of the large, *publicly-held* brokerage houses indicate profits for this period will deteriorate further to possibly half Q2's level. Only publicly-held Discounters will show an upturn for Q3, thanks, in large part, to heavy commissions in the summer (though post-Labor Day results were weak).

Profits from principal transactions, an important revenue source for the largest firms (NFLs, LIBs, as well as large Regionals) were down markedly at the public firms in Q3. Investment banking revenues also softened in the summer. Commissions were flat, except at the Discounters, when September's trading vacuum reversed the benefits of July's and August's selling spree. September's close also saw some trading and investment losses posted, as firms marked their inventory to market. On the equity side alone, prices tumbled 18% from mid-July (market's peak) to the quarter's close, These positions, however, may eventually show profits when eventually closed on the books. Risk arbitrage losses were heavy also at several large firms.

Exhibit 2



Commission Revenues

There are always silver linings among dark clouds of data, but we'll take a "first the bad news" approach and save the good to last. By annualizing the first half results, some painful trends are obvious. Commissions are down 11% this year and current NYSE volume, averaging under 160 million shares daily this year (Exhibit 3) and dwindling since August's highs, doesn't portend improvement by year's end. If the trend holds, 1990 will be the second lowest year for industry commissions since 1985 (only 1988's $8 billion tally was worse). However, institutional commission rates, reportedly averaging around 5¢ per share, aren't likely to continue their long-term decline. Meanwhile, the press has reported that some firms have begun raising some retail rates.

As we've noted in previous issues of *Trends*, commissions continue to be less important to the industry's overall revenue picture. For the first half of this year, commissions accounted for only 16% of total revenues, starkly lower than in the pre-May Day fixed commission rate environment of the Sixties and early Seventies (Exhibit 4).

Exhibit 3

NYSE AVERAGE DAILY VOLUME

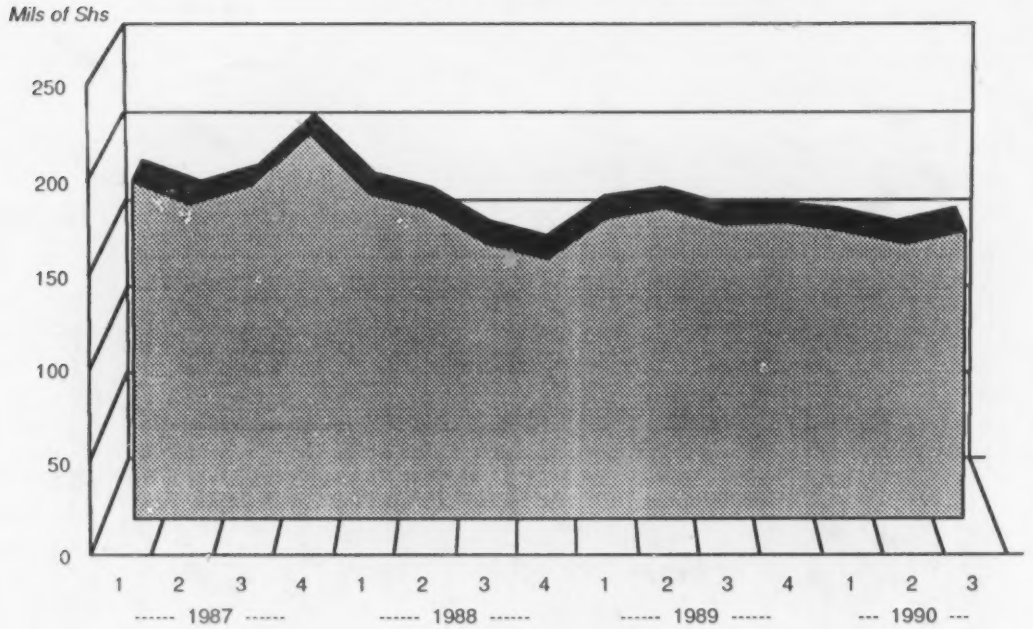
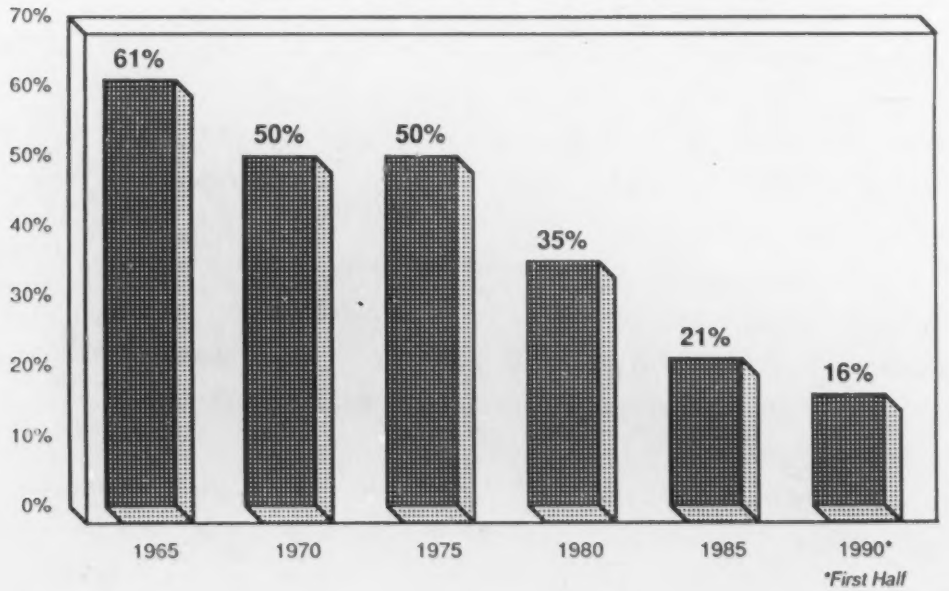


Exhibit 4

COMMISSIONS' SHARE OF INDUSTRY REVENUES



Revenues to Fall

For the first time since the Seventies, total industry revenue will not set a new record high. First half results project a decrease in revenues from last year's $59.5 billion to $55.3 billion, or down 7%. Although commissions, underwriting, margin interest and other revenue sources are all falling this year, the bulk of the decrease, nearly $3 billion, will come from "other securities related" revenue. Approximately 70% of this revenue line is interest related, a healthy portion from repo activity. Also, the Large Investment Banks post just over half of the industry's total revenue reported on this line.

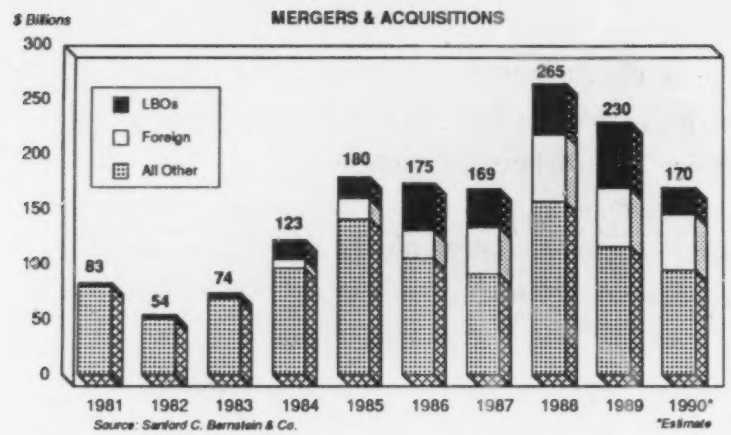
Reduced Repos

The industry's repo book decreased $23 billion, or 8%, over the 12 months ended June 30, 1990. It's reverse repo book dropped $43 billion or 16% over the same time frame. Both drops were mainly from the Large Investment Banks which dominate this business and the cutback breaks the trend of a long-term build up of these businesses in the Eighties. At year-end 1980, reverse repos accounted for $31 billion of assets in the industry; by 1989 they were $220 billion. Meanwhile, repos, as liabilities, grew from $32 billion to $278 billion. Now that firms have been forced to hold large bridge loans, some souring, following the collapse of the junk bond market, their short-term liquidity is down and they are moving to reduce short-term exposure.

Slashed M&A Activity

Another 20% of the "other securities related" revenue line comes from merger and acquisition-related fees which are off dramatically since the high-yield market tanked late last year. According to Michael Goldstein at Sanford C. Bernstein & Co., domestic M&A activity will fall by more than a third this year to $170 billion. That will be about half the heated level just two years ago (Exhibit 5). He also estimates that leveraged buy-out activity will be down 60% this year to just $25 billion; even foreign mergers in the U.S. will fall over 20% this year to just $42 billion.

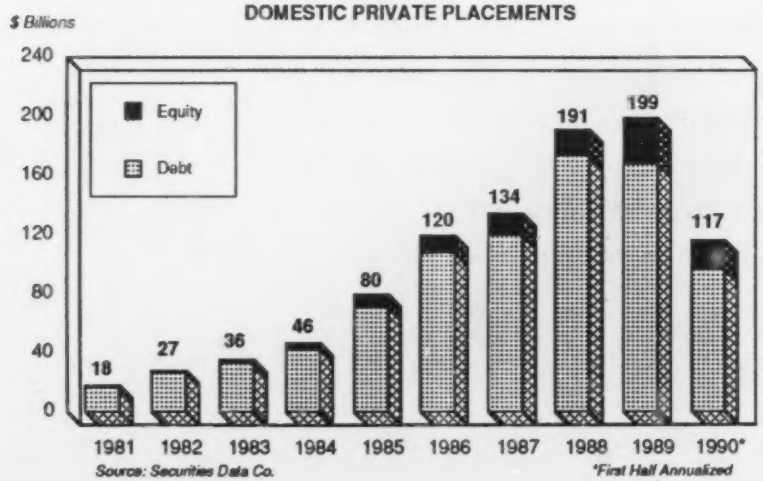
Exhibit 5



Private Placements

The final 10% of the "securities related" line is attributable to private placement fees. After a decade of spectacular growth, not even stunted by the crash of 1987, the private placement market is expected to drop over 40% this year (based on first half results annualized, Exhibit 6). Three segments previously fueling the growth post-crash — acquisition-related financings, junk bonds and ESOP financings — nearly evaporated this year, all down between 50% to 70%. Acquisition-related private placements and junk bonds are inextricably intertwined since junk financed much of the M&A done in the Eighties but suffered the wrath of investor aversion since late last year. Also, the recently popular ESOP-related private placements were curtailed by IRS rule tightening.

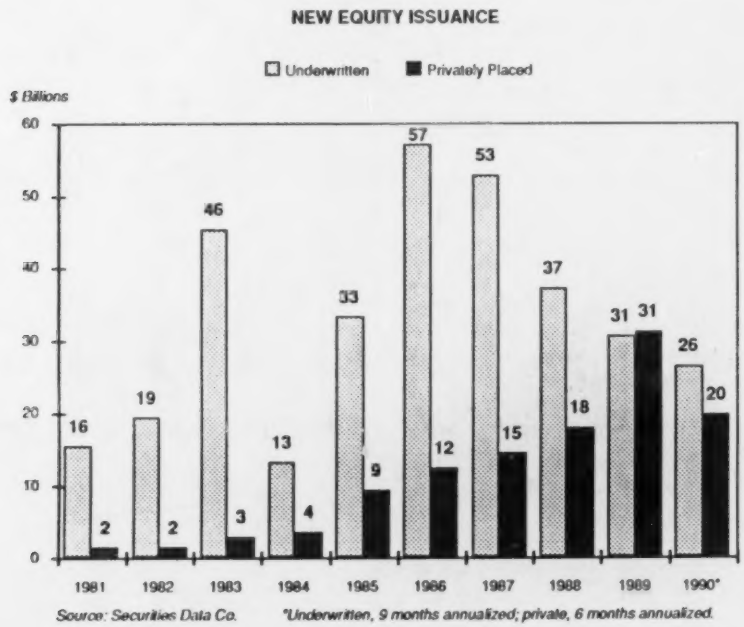
Exhibit 6



Still, all areas of the private placement market witnessed declines this year. For debt issues, investors mainly sought investment grade issues just as these high credits reduced their private borrowings.

Privately placed equity reached a record $31 billion last year, thereby slightly exceeding underwritten equity for the first time ever. Underwritten equity, of course, had seen much higher levels during previous boom times but privates kept growing well after the crash as underwritings dwindled. This year, however, the downward trend in equity issuance caught up to the private market (Exhibit 7). Although the much heralded SEC Rule 144A was not available for issuers until the end of the first half, its use to date has been very limited and will have little impact on the private market this year.

Exhibit 7



Source: Securities Data Co. **Underwritten, 9 months annualized; private, 6 months annualized.*

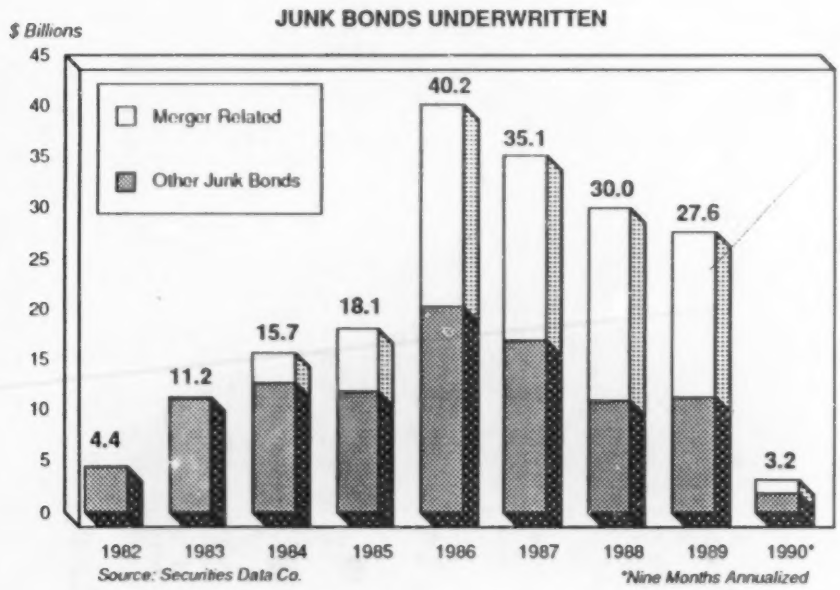
Large Investment Banks Post Investment Losses

Another revenue source tailing off for "the industry" is "investments for a firm's own account." Last year's closing quarter saw the "industry" post $221 million in investment account losses. This year's first quarter saw red ink again: $131 million. Although the second quarter showed an upturn to a minimal profit of $92 million, this line is still in the red for the year. Furthermore, this loss comes on the heels of a 65% decrease in

investment gains from 1988 to 1989. The losses were almost entirely on the books of the Large Investment Banks, a group caught late last year with sizable inventories of junk bonds, equity stakes and bridge loans as the market for these products tanked.

Meanwhile, industry underwriting revenues, having fallen 20% last year, are down another 15% in 1990. Two of the highest margin products, equity and junk bonds, are very weak. Junk bond underwritings are practically nonexistent (Exhibit 8) and, as we saw earlier (Exhibit 7), *equity underwritings are at their lowest level in five years.* Again, the largest firms (NFLs and LIBs) dominate the industry's aggregates with over three-quarters of all underwriting revenue.

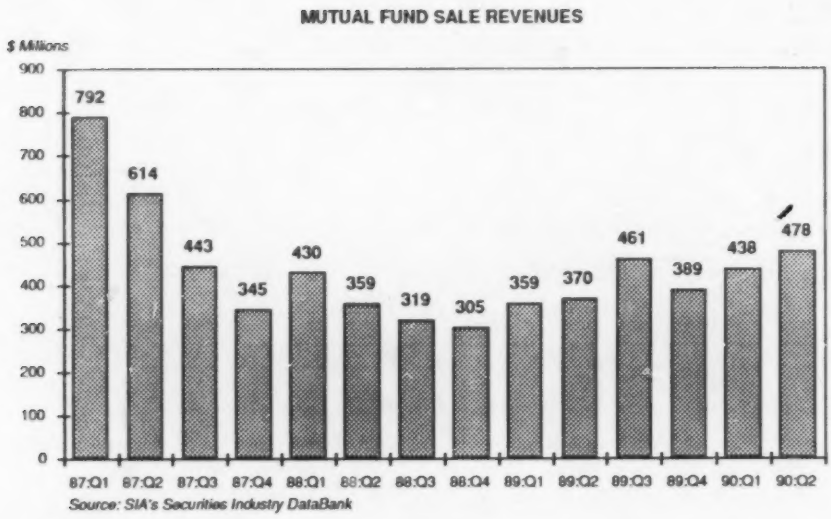
Exhibit 8



Mutual Funds

One area showing steady growth the past few years is the sale of mutual funds. *Investment Company Institute* figures show record sales of mutual funds, about evenly split between equity and income funds, so far this year. Although revenues are still only three-fifths the peak they reached during 1987's first quarter, they are still running at a post-crash high and trending up (Exhibit 9). Approximately 70% of these revenues are earned by the National Full Line firms with the majority of the balance earned by Regional firms.

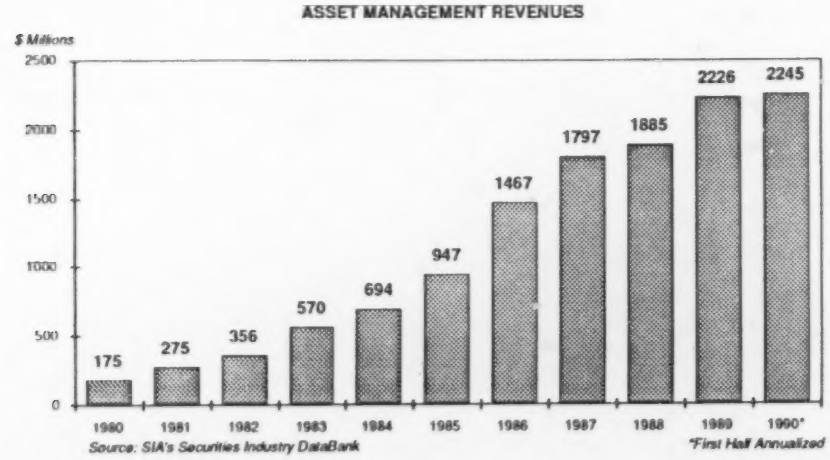
Exhibit 9



Asset management Fees

Another retail revenue source enjoying an upward trend is asset management. Many securities firms began pushing the concept of "asset gathering" during the late 1980s, i.e. encouraging the retail workforce (through various incentives) to bring customer assets "in-house." Hopefully, once in-house, more and more of a customers' assets will be concentrated within the firm thus netting more fee income through managing these assets (Exhibit 10) as well as creating additional revenue from more product lines which

Exhibit 10



otherwise would have been lost to other institutions, i.e. banks and mutual fund companies. This revenue source, more than half of which is booked by a handful of National Full Line firms, peaked in last year's final quarter ($713 million). This year's first two quarters, however, were still the next best periods ever ($529 and $594 million).

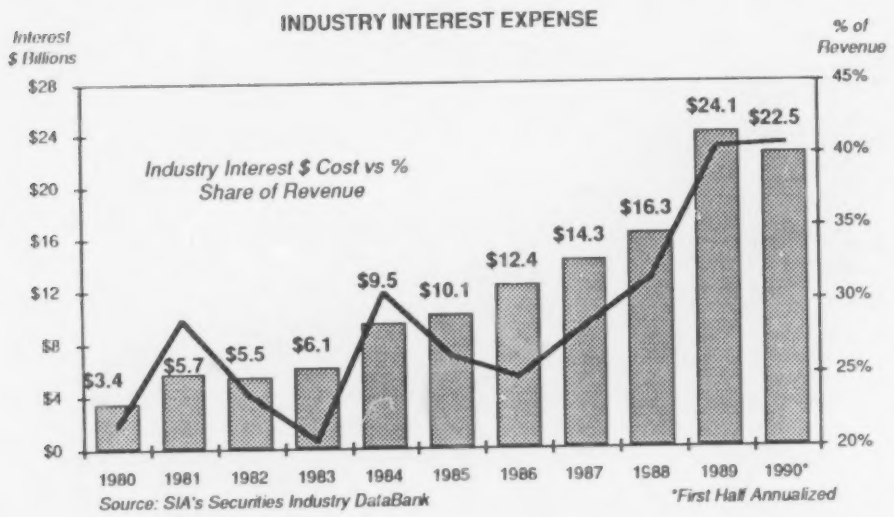
Margin Interest

Industry revenues from margin interest has been pretty much flat the past four years at just over $3 billion annually, or 6% of total revenues. Nevertheless, it is running 15% below last year's record level, with the drop-off in this investment borrowing offsetting recent gains from brokerages' new home equity loan credit lending. The mix of firms earning margin interest has not changed much either. NFLs still dominate with about half the industry revenues from this source. LIBs still have 20%, Regionals maintained their 10% share, while Discounters have shown some growth and now have 7% of all revenues from this source.

Interest Expense

On the expense side of the P&L, gross interest expense is the industry's largest cost item, followed closely by compensation costs. Gross interest expense this year is running about 7% below last year's record level of $24 billion. But since total revenues also are down in 1990, interest's bite out of revenue is still about 40%, the same as last year. This is still a record high, however, and significantly higher than 1988's 32% bite or 1987's 28% cut from total revenues (Exhibit 11). Large firms increased their repo/reverse-repo businesses at a faster clip than other business lines in recent years. The LIBs and NYCs still dominate this expense line, accounting for about 50% and 30%, respectively, of the total industry bill. NFLs, meanwhile, are down to only 18% of the industry's interest expense bill but, as mentioned, we've recently lost three major NFLs and their inventory book.

Exhibit 11

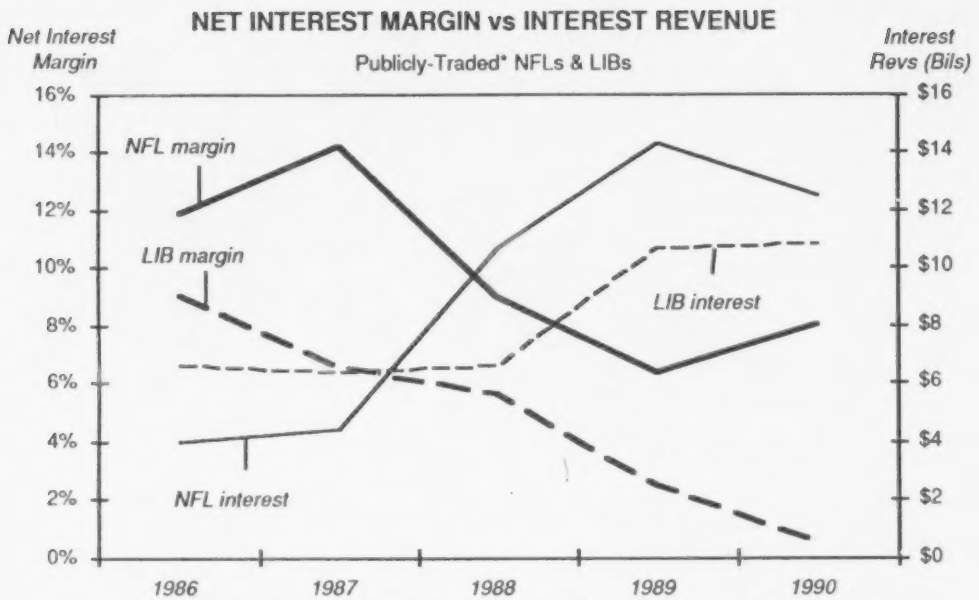


Of course, charging off gross interest expense without crediting the contra side of the equation, interest revenue, can unfairly distort one's analysis of cost control measures or profitability. For just this reason, many firms accurately decide to report their interest net of expenses as a revenue line on their P&L. Unfortunately, FOCUS reporting does not allow for this analysis.

Net Interest Income

However, If we look at the P&Ls of four publicly held NFLs (three prior to 1987) and three public LIBs, we see that, with the notable exception of 1989-90 for one investment bank, all firms consistently reported net interest income. On the other hand, as the industry has become more and more capital intensive and built up huge inventory and deal financing costs, interest expense exploded along with interest revenues and reduced the marginal returns earned from net interest income. As these publicly held NFLs' interest revenues and costs exploded (Exhibit 12), their margin of net interest income to total interest revenue fell from about 14% to 6% last year. As interest revenues and costs retreated in 1990 (annualized), the margin rebounded somewhat to 8%. Similarly, as the three LIBs' interest exploded, the marginal return declined to under 1% this year (although this is dragged down by huge net interest costs of one LIB). It should be noted that although Exhibit 12 shows the publicly-held NFLs with higher gross interest data than the publicly-held LIBs, the complete LIB group has much higher aggregates than the NFLs in total (but the marginal return trends should be similar for all).

Exhibit 12



*Note: 3 publicly traded NFLs for 1986-87, 4 thereafter; 3 public LIBs throughout.

Higher Profit Margins

Nevertheless, net interest income is still a positive to the bottom line of most firms and a large one at that, despite shrinking margins. For comparative purposes, Exhibit 13 shows the pre-tax profit margins of groups of firms during the past 10 years two different ways: with either gross interest revenue or net interest revenue included in the divisor. Only the LIBs, with their heavy capital markets and interest commitment, have a significant variance when calculating profit margins both ways (Exhibits 13 and 14). The LIBs' profit margin using net interest income is about double the FOCUS Report measurement (gross interest revenue included in the denominator), which further emphasizes this group's significantly higher profitability than other firms in the industry. Since the LIBs are such a large factor in industry aggregates, the total industry profit margin variance is also exacerbated by the LIBs' heavy weighting. The NYCs hava also mirrored the LIBs' performance here the past few years.

Exhibit 13

PRE-TAX PROFIT MARGINS
(In Percent)

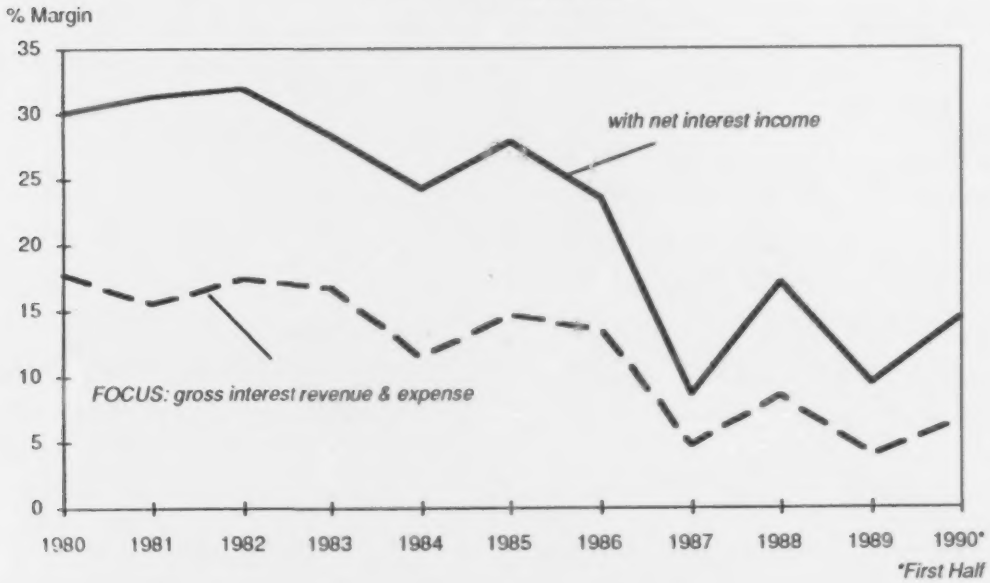
Firm Category	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990*
National Full Line Firms	10.9	6.9	8.8	8.6	(0.9)	5.6	6.9	(0.9)	(0.3)	(0.1)	(5.2)
Large Investment Banks	17.7	15.4	17.4	16.7	11.4	14.6	13.5	4.7	8.4	3.9	6.4
Regionals	14.7	11.1	11.1	12.6	2.6	9.4	11.0	5.5	2.6	4.4	(0.4)
New York City Based	14.7	12.6	14.0	18.3	8.9	12.2	16.1	2.9	7.4	4.2	1.6
Discounters	17.5	12.2	13.6	14.0	0.3	8.9	15.7	8.6	3.1	7.2	7.3
All NYSE Firms	**14.1**	**10.8**	**13.1**	**12.9**	**5.2**	**10.7**	**11.0**	**2.2**	**4.8**	**3.1**	**0.8**

PRE-TAX PROFIT MARGINS, LESS INTEREST EXPENSE
(In Percent)

Firm Category	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990*
National Full Line Firms	13.0	8.8	10.3	9.9	(1.2)	6.9	8.5	(1.1)	(0.4)	(0.2)	(6.8)
Large Investment Banks	30.0	31.3	31.8	28.3	24.1	27.7	23.4	8.5	17.1	9.4	14.4
Regionals	16.4	13.2	12.5	13.7	3.0	10.4	11.8	5.9	2.8	4.9	(0.5)
New York City Based	18.8	16.5	16.8	21.5	11.1	14.1	20.7	4.4	13.2	11.8	4.7
Discounters	17.9	13.3	15.4	15.5	0.4	10.5	18.2	9.9	3.9	9.4	9.6
All NYSE Firms	**18.0**	**15.2**	**17.1**	**16.3**	**7.4**	**14.5**	**14.6**	**3.1**	**7.0**	**5.2**	**1.3**

Exhibit 14

LIBs' Pre-Tax Profit Margin



Compensation Costs

On the expenditure side of the industry's P&L, the industry's largest non-interest expense is compensation. Total compensation is down to a third of all expenses this year from 41% in 1987, including gross interest expense. With the escalating gross interest expense netted out, however (as most firms do beyond their FOCUS filings), compensation is still a whopping 57% of total costs, about even with 1987's 58%. Nevertheless, total compensation costs are running 2% below last year's level based on first half results annualized. For most of the industry, the progress in reducing compensation costs is actually much better than this 2% figure would indicate.

If we split the industry into the 10 largest capitalized firms, "Top 10," and then everybody else, "all other firms," we find that, except for the Top 10, the industry has been doing an excellent job of cost reduction. Registered representative compensation (which is almost entirely RR payout in most FOCUS filings) at the non-10-largest firms is running about 6% below last year's level. This is in line with this group of firms' 7% drop in commission revenue. With an overall industry drop of 11% in commission revenue so far this year, the non-largest firms' smaller 7% drop-off is impressive. The strategy of trimming lower-end producers from staff is paying off — the non-largest firms pared back their average RR workforce 9% in this year's first half compared to all of last year with, as mentioned, a smaller 6% drop in overall production.

Problems at the Top

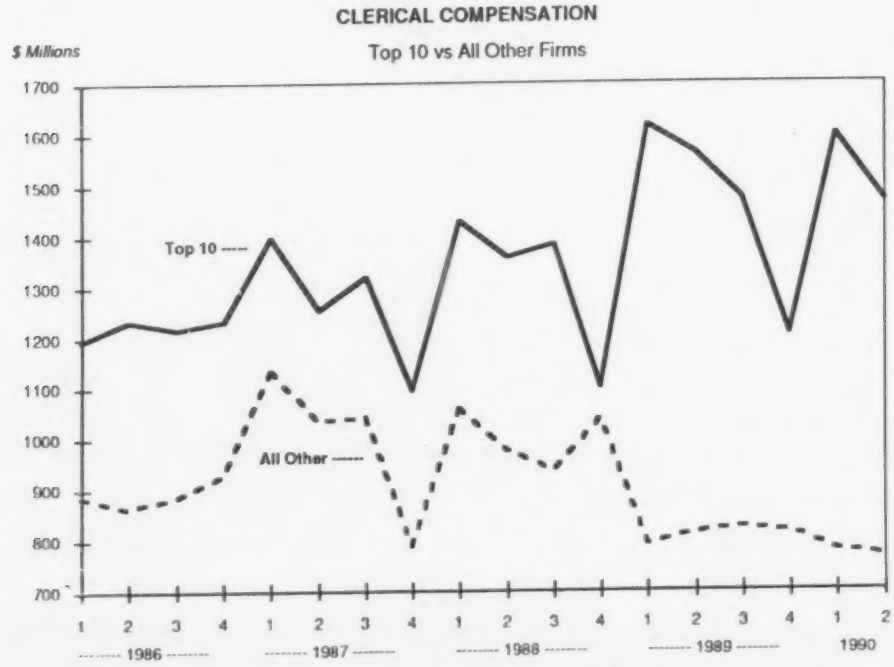
At the Top 10 firms, particularly the largest wirehouses, the reverse was true. The Top 10's commissions fell nearly 16% while RR compensation fell only half that rate, 8%. The NFLs, alone, had an 18% drop in commissions with half that drop in RR compensation. Further, both the Top 10's average RR employment in the first half is down less than 5% from last year's average, while production fell three times that rate. At the wirehouses, gross commissions are down 18% and average RR employment is down just under 10%.

Crediting total revenue from mutual fund sales on top of commissions would temper the comparison somewhat, but even here the NFLs' performance badly trails all other firms. The NFLs had only an 8% growth of mutual fund revenue in 1989 and a 10% growth rate this year (annualized) while all other firms' growth was 25% and 33%, respectively.

Higher Compensation

The 10 largest firms (by capital), particularly the largest wirehouses, have obviously not done as good a job as the rest of the industry in yielding higher production from a smaller group of higher-end producers, but this is not surprising. The Top 10 firms have typically employed from 50% to 60% of all RRs in the industry while generating less than half the industry's commission revenues. Looking at the wirehouses, alone, we find that they still employ 61% of all RRs from a year before the crash and for every year since right up until today, despite the shrinking workforce and the loss of three NFLs — E.F. Hutton, Thomson McKinnon and Drexel. Meanwhile, their share of industry commissions has now shrunk to below 40% of the total. And though they still dominate the mutual fund sales arena, their share of this revenue base fell from 77% in 1988 to just 70% this year.

Exhibit 15

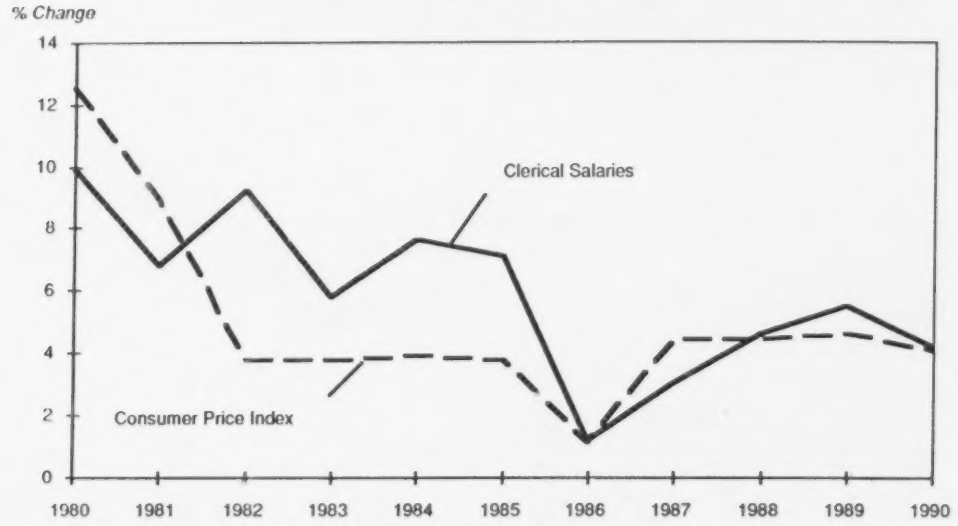


Where the Top 10 firms show the most divergence from the rest of the industry's compensation trend is on the non-producer side. Exhibit 15 shows the FOCUS "clerical compensation" line for the Top 10 firms and everyone else combined. The non-largest firms have shown a pretty much downward sloping clerical cost trend since the record high in 1987's first quarter, also the record high quarter for industry profits. This group is showing an additional 5% reduction in clerical compensation costs so far this year on

a non-producer workforce that is, on average, 8% below last year's level. The steadily lower expense is particularly laudable since firms still have had to grant increases (albeit lower in recent years) to their remaining clerical workforce to maintain real inflation-adjusted paychecks (Exhibit 16) and to remain competitive in the job market. Further, securities firms have faced the same personnel cost increases as other industries, i.e. medical benefit costs which have doubled or tripled the past few years.

Exhibit 16

SECURITIES INDUSTRY CLERICAL SALARIES vs CPI



Source: SIA Reports on Production & Earnings of RRs

The 10 largest firms continue to see their "clerical compensation" cost line rise as their non-producer workforce decreases. Why? Several CFOs of these firms explain that their "core" clerical workforce, i.e. operations, secretaries, etc., have witnessed the same cost reductions as the rest of the industry. Where increases have occurred in the non-producer labor force, it has mainly been in some high pay scale areas. Several large firms have been building their technology areas, particularly firm-wide workstations which have created a big demand for some very competitive and high-paying technology professionals. Also, they explain that the cutbacks in clerical staff have been concentrated in the lowest paying areas in operations while high-end scale areas, such as legal and compliance, are not being trimmed and in fact may need to be bolstered.

The large firms have the same cost pressures as the rest of the industry also, such as the COLAs and medical costs, but have one large additional cost in this line which is concentrated among these firms — traders and investment bankers. Much of the traders' and investment bankers' compensation is lumped into the clerical compensation line, and these personnel are concentrated at the larger firms. In fact, in the case of higher clerical compensation, it is the Large Investment Banks, and not the NFLs, which have shown the cost increases. The heavy Q1 spike-ups in Exhibit 15 was attributed to FOCUS filers predilection for lumping firm-wide bonuses and accruals into the clerical line. Still, recent announcements of further staff cuts at the LIBs, particularly investment bankers, may help drive this cost line down in the future.

The Good News - Other Expenses

As promised earlier, we saved the good news to last. All other expenses for the industry in 1990 (first half annualized), except for non-recurring charges associated with downsizing (from large NFLs), are running below last year's levels. As Exhibit 17 shows, compensation, as mentioned, as well as communications and promotional costs are all running more than 2% below 1989 levels. Error account losses are down 20% from 1989 while gross interest expense, floor costs and regulatory fee expenses are all down 7%. Occupancy & equipment costs are also down 4%.

The NFLs' cost cuts mirror the industry's cuts in direction, down, but have substantially higher percentage movements. For instance, floor costs, promotional expenses, EDP and regulatory fees were all down about 12% to 13%.

The LIBs also showed a drop in most expenses but showed a 33% rise in error accounts (although the total costs here are minimal), and they still showed a 3% rise in occupancy costs despite the substantial softening in the commercial real estate market over the past few years. Overall, total expenses are down 5% industry-wide; down 7% and 8% at the NFLs and LIBs, respectively. Regional and NYC-based regionals, each showed a 3% rise in expenses so far this year (first half annualized), but this is substantially below prior-year cost increases. Discounters, meanwhile, showed a 13% cost boost but alongside a revenue base which grew as fast.

Exhibit 17

NYSE BROKER-DEALER INCOME STATEMENT

(In $ Millions)

REVENUE:	1989	1H90A	89 - 90 % Change
Commissions	10,150.7	9,057.4	-10.8%
Trading Gains	12,343.3	13,592.0	10.1%
Investment Gains	488.1	-77.2	-115.8%
Underwriting Revenue	4,120.0	3,507.8	-14.9%
Margin Interest	3,723.1	3,160.8	-15.1%
Mutual Fund Sales	1,579.5	1,831.4	15.9%
Fees, Account Supervision	2,225.8	2,245.0	0.9%
Research	27.1	16.0	-41.0%
Commodities	1,407.6	1,862.2	32.3%
Other Securities Related	20,337.5	17,510.0	-13.9%
Other Unrelated	3,134.4	2,633.4	-16.0%
TOTAL REVENUE	59,537.1	55,338.8	-7.1%
EXPENSES:			
Total Compensation	18,825.8	18,400.0	-2.3%
RR Compensation	7,539.3	7,009.8	-7.0%
Clerical Compensation	9,103.2	9,211.2	1.2%
Floor Costs	1,855.4	1,724.6	-7.0%
Communications	2,374.2	2,312.0	-2.6%
Occupancy & Equipment	3,163.3	3,040.2	-3.9%
Promotional Costs	954.6	933.2	-2.2%
Interest Expense	24,069.8	22,478.6	-6.6%
Errors, Bad Debts	421.8	336.8	-20.2%
EDP	710.7	676.8	-4.8%
Regulatory Fees	437.5	405.0	-7.4%
Non-Recurring Charges	239.8	528.6	120.4%
Other	4,642.2	4,061.4	-12.5%
TOTAL EXPENSES	57,695.1	54,897.2	-4.8%
PRE-TAX NET INCOME	1,842.0	441.6	-76.0%

Source: SIA's Securities Industry DataBank

Conclusion

In sum, the industry is beginning to show progress in reducing its costs, particularly compensation costs, but plenty of problems remain, mostly from industry-bred practices. As we mentioned in our May issue of *Trends*, some of the problem compensation practices employed in the industry are a holdover from the partnership era, such as firm-wide bonuses not proportionate to profits, or even granted during periods of losses. Although long-standing practices are now being changed, some firms still make payments to both profitable and unprofitable departments on the premise that business cycles will even this out in the end, which may not happen.

Incentive compensation is still revenue-oriented, not profit-oriented. Compensation is often irrational: systems or secretarial personnel working for capital markets are compensated vastly greater than the same functionaries in operations, even though they perform the same function. Besides being an unnecessary expense to a firm's overall budget, this practice has exacerbated internal strife between retail and capital markets personnel.

And finally, firms keep paying high producer compensation in order to not lose high producers to the competition. However, the higher compensation often applies to lower-end producers as well. A steeper sliding scale, or a profit-measured scale, would better suffice. Although these problems are being widely discussed, they are not being adequately addressed yet. However, the magnitude of the industry's problems over the past three years of industry recession would have been a challenge to any management.

George R. Monahan
Director of Industry Studies

UNDERWRITING

	OCTOBER 1990	OCTOBER 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$22,365.7	$35,934.7	-37.8%
Common Stock	$396.8	$2,593.0	-84.7%
# of Common Stock Issues	12	48	-75.0%
Preferred Stock	$375.0	$780.0	-51.9%
# of Preferred Stock Issues	7	9	-22.2%
Corporate Debt	$21,593.9	$32,561.7	-33.7%
# of Corporate Debt Issues	95	132	-28.0%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$4,690.8	$7,121.0	-34.1%
# of Issues	255	423	-39.7%
Competitive	$2,964.1	$3,058.1	-3.1%
# of Issues	280	307	-8.8%

Source: Securities Data Co.

PRICES
(END OF MONTH)

	OCT. 1990	OCT. 1989	% CHG OCT. 1990-1989
DOW JONES INDUSTRIALS	2442.33	2645.08	-7.7%
STANDARD & POOR'S 500	304.00	340.36	-10.7%
NYSE COMPOSITE	166.17	188.24	-11.7%
AMEX MARKET VALUE INDEX	287.79	370.58	-22.3%
VALUE LINE COMPOSITE	179.60	258.05	-30.4%
NASDAQ COMPOSITE	329.84	455.63	-27.6%

YIELDS
(MONTHLY AVERAGES)

	SEP. 1990	SEP. 1989	BASIS POINT CHG 1990-1989
BOND BUYER INDEX (20 BOND)	7.53%	7.26%	27
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.56	9.01	55
Baa CORPORATE	10.64	9.91	73
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.91	(1)

VOLUME

	SEP. 1990	YTD 1990	SEP. 1989	YTD 1989	% CHG YTD 1990-1989
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	141.3	156.8	151.8	166.1	-5.6%
AMEX (MILS.)*	11.7	13.8	12.6	12.2	13.1%
NASDAQ (MILS.)*	110.3	136.0	131.3	132.5	2.6%
REGIONAL EXCHANGE (MILS.)*	20.9	24.7	24.5	26.5	-6.8%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$82,787	$1,026,714	$120,174	$1,165,773	-11.9%
AMEX (MILS.)	2,562	30,218	3,977	32,295	-6.4%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	7,530	89,522	9,255	88,771	0.8%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	10,932	128,776	15,336	155,630	-17.3%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	48.4%	49.7%	49.0%	51.6%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,777	98,191	9,688	97,368	0.8%
AMEX OPTIONS	2,742	26,887	3,740	31,033	-13.4%
COMMODITY	20,488	210,647	19,888	204,497	3.0%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
SIA Fact Book -- The Securities Industry of the Eighties	Fact Book designed to provide a decade of data on the most frequently asked questions on the securities industry and capital markets. In 31 pages of tables and charts, the book covers various aspects of the securities industry including: the brokerage community, capital markets, stock market activity, mutual funds, futures and options, retail and institutional trading and holdings, economic data and vital foreign market statistics.	SIA Research Department Members: $25; Others: $50
"Desperate Hours... From Congress Some Late Changes in Taxes, Spending"	Quick look at the largely overlooked budget provisions affecting taxation of securities and transactions involving junk bonds and leveraged buyouts and review of basic tax changes. Notes that although many people thought that the purpose of the annual budget exercise was to cut spending as well as to raise taxes, only defense registers an actual spending reduction in the first year -- $29 billion less than in fiscal 1990. There aren't any other spending cuts in the whole 5-year package, only reductions from previously approved program levels, adjusted upward for inflation. In fact, for every new dollar in taxes raised during the 5 years, federal spending is to rise $1.90.	Barron's November 5, 1990
"Investment Management in the 1990s"	Author Arthur Zeikel's view of the future. Notes two trends which will dominate investment management activity: 1. Investing around the world is a true growth business. The nature of the growth, however, will engender increased competitive pressures for most organizations. 2. The appetite for and appeal of owning individual securities has sharply declined and will continue to do so.	Financial Analysts Journal September/October 1990

Item	Description	Source
"Redefining Strategies for the 90s"	Three views of what will work in the "maturing" securities industry. 1. Downsizing or rightsizing stresses what firms need to know before making changes -- the numbers and what they mean, the firm itself, the competition and the risks. 2. What the customer wants reviews the new needs of the institutional customer. 3. From profit drain to management tool makes the case for treating bonuses as capital.	Investment Dealers' Digest October 29, 1990
"The Sheikhs of Wall Street"	Author writes that control of the oil-price mechanism has changed hands once again. Over the last decade U.S. investment banks, with an appetite for risk far greater than the traditional players, quietly have carved a niche for themselves in the industry. Their entry has coincided with a profound change and these banks are seen to have the capacity to move markets and trade as much as the major companies.	Euromoney October 1990
"Can John Reed Rock Citicorp Out of Its Rut?"	Bad loans, thin reserves, and a worried Wall Street are leaving John Reed a lot less room to maneuver. Article chronicles bank's problems and strategy for dealing with them. Reed is reviewing existing businesses with a view to selling off or closing poor performers. Staff cutbacks are already under way, and by the end of 1991, Citibank will trim its payroll by at least 2,000.	Business Week November 12, 1990
"Last one out of Gotham, close the door"	The Economist takes a look at recent developments in NYC. Finding: New York looks set to survive, even prosper -- if it can slow the exodus of its middle class. The roots of some city problems are national, not local, and are beyond the capacity of the city to contain, let alone cure. More money would help somewhat but New Yorkers are among the most heavily taxed people in the U.S.	The Economist October 20, 1990

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Securities Industry

TRENDS

An Analysis of Emerging Trends in the Securities Industry
Produced by the SIA Research Department

Vol. XVII, No. 1

April 5, 1991

Securities Industry Posts First Annual Loss Since 1973

Highlights

1. Last year was the worst on record for the securities industry – NYSE member firms reported a record annual pre-tax loss of $162 million for full-year 1990. Since records became available in 1965, the only other reported annual loss for the industry was back in 1973, a $72 million pre-tax loss. For the National Full Line firms, the bite was even worse last year: a record $678 million pre-tax loss.

2. The annual loss was widely expected and hardly surprising – NYSE member firms reported aggregate losses in four of the past five quarters. The string of losses began with 1989's fourth quarter pre-tax loss of $92 million followed by a 1990 first quarter loss of $487 million. The only profitable quarter last year, Q2, showed $708 million in pre-tax net income; followed by losses of $189 million in Q3 and $194 million in Q4.

3. In just over a year's time, the industry's equity capital base shrank by $4 billion or 15% from a record $27.1 billion in 3Q89 to $23.0 billion by 4Q90. This equity base is the smallest since 1986. Further, total capital (equity plus subordinated debt) fell 9% last year from a record $39.3 billion at year-end 1989 to $35.8 billion at year-end 1990, the lowest level since the 1987 crash.

4. Securities industry employment has contracted 20% since the crash, from 262,000 to 210,000; this is the lowest industry workforce since 1984.

5. Commission revenues declined each quarter throughout the year finishing at a mere $2 billion in the fourth quarter. This is the same level of commission revenues earned from late 1982 to early 1984. For the year, total commissions of $8.9 billion were down 13% from 1989, and a sharp 30% below 1987's peak.

6. Although partly due to the shrinkage of the number of firms in the industry, securities firms, almost universally, showed across-the-board expense cuts last year. NFLs and Large Investment Banks had expense cuts of 11% and 9%, respectively; Regionals managed a 5% decline; Commission Introducing firms had a 6% cut, while unclassified firms showed cuts of 3%.

Securities Industry Association

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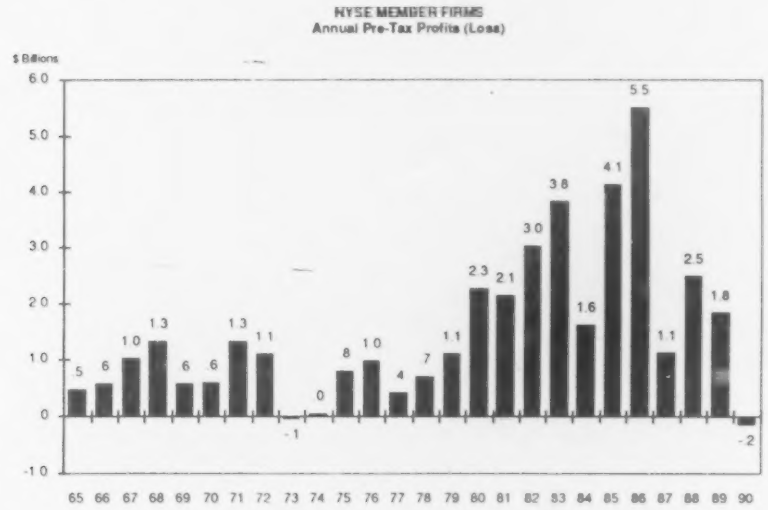
Introduction — Worst Year on Record

For the four out of five securities industry professionals still employed in the industry three full years since "the crash," February appeared to be finally that bright light at the end of the long, dark tunnel. March came in like the proverbial lion also, and didn't exactly go out like a lamb. Of course, since official fourth quarter data was only now released, the full story will have to wait until around Memorial Day, when 1Q91 data should first become available.

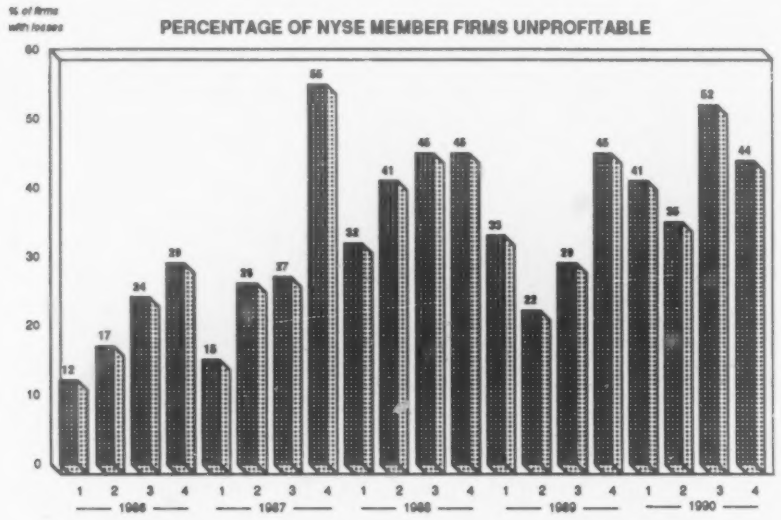


Despite this first, in a long while, slightly bullish opening, a reflection on the year just past catapults us back to the more sobering period of the industry's three years of recession. Last year was, in fact, the worst on record for the securities industry. New York Stock Exchange (NYSE) member firms dealing with the public[1] reported a record annual pre-tax loss of $162 million. For the 10 largest firms, however, the bite was even worse: a record $574 million loss pre-tax.

---

[1] NYSE member firms dealing with the public number only about 330 but, because of the heavy concentration of the largest firms among this group, the NYSE group accounts for about 90% of the securities business conducted by the 5,800 members of the National Association of Securities Dealers (NASD) and 80% of the business conducted by the approximately 9,000 firms registered as broker-dealers with the Securities and Exchange Commission (SEC). Unless otherwise noted, references in *Trends* to "total industry" or "securities industry," refer to the NYSE group. Data for the NYSE group and subcategories of firms, is available quarterly and annually from SIA's *Securities Industry DataBank*.

Since records became available in 1965, the only other *annual* loss reported for the industry was back in 1973 – $72 million. The 1990 loss was widely expected and hardly surprising – NYSE member firms have reported aggregate losses in four of the past five quarters and one-third to one-half of these members have consistently posted red ink each quarter since the "crash." With these continuous losses, it is hardly surprising that the universe of securities firms continues to shrink from closings and mergers. The number of NYSE member firms dealing with the public, which account for 80% of all the securities business conducted in the U.S., fell to around 330 firms at year-end 1990, the lowest ever since records were kept. NASD membership at year-end 1990, at around 5,800, is the lowest since 1984.



The string of losses began in the final quarter of 1989 with an industry-wide pre-tax loss of $92 million. This loss was entirely attributable to fourth quarter "non-recurring" charges of $191 million posted by the National Full Line Firms (NFLs)[2] and associated with write-offs from their downsizing to haul in costs. Without this, the quarter would have shown an industry-wide $100 million profit.

---

2 The NFLs are the largest full service brokerage firms (also known as "wirehouses") with an extensive national and international branch network system. This group, one of the various selection of firm categories available on the *Securities Industry DataBank*, accounts for the vast majority of the U.S. securities industry's retail brokerage services, revenues and employees. These firms, currently numbering seven, provide a broad array of virtually every financial service and product to both households and institutions. With one exception, all are headquartered in New York City. Also, their investment banking businesses are comparable to those of the "Large Investment Banks" (LIBs). Further information, as well as quarterly Income Statements and Balance Sheets, for the NFLs, LIBs, Regionals, Discounters, and other firm categories, are available on SIA 's *Securities Industry DataBank* (contact SIA Research Department).

INCOME STATEMENT
NYSE Member Firms Doing a Public Business
(In $ Millions)

	1989	1990	$ Change	% Change
REVENUE:				
Commissions	10,150.7	8,878.1	-1,272.6	-12.5%
Trading Gain	12,343.3	13,175.0	831.7	6.7%
Investment Account Gain (Loss)	488.1	-283.1	-771.2	-158.0%
Underwriting Revenue	4,120.0	3,243.3	-876.7	-21.3%
Margin Interest	3,723.1	3,075.3	-647.8	-17.4%
Mutual Fund Sale Revenue	1,579.5	1,669.1	89.6	5.7%
Fees, Asset Management	2,225.8	2,241.0	15.2	0.7%
Research Revenue	27.1	18.4	-8.7	-32.1%
Commodities Revenue	1,407.6	1,685.8	278.2	19.8%
Other Related to Securities Business	20,337.5	17,389.3	-2,948.2	-14.5%
Other Unrelated	3,134.4	2,941.5	-192.9	-6.2%
TOTAL REVENUE	**59,537.1**	**54,033.7**	**-5,503.4**	**-9.2%**
EXPENSES:				
Compensation	18,825.8	17,715.2	-1,110.6	-5.9%
Floor Costs	1,855.4	1,731.0	-124.4	-6.7%
Communications	2,374.2	2,221.7	-152.5	-6.4%
Occupancy & Equipment	3,163.3	3,092.2	-71.1	-2.2%
Promotional Costs	954.6	878.4	-76.2	-8.0%
Gross Interest Expense	24,069.8	22,717.2	-1,352.6	-5.6%
Error Account Losses & Bad Debts	421.8	296.3	-125.5	-29.8%
EDP Costs	710.7	684.6	-26.1	-3.7%
Regulatory Fees & Expenses	437.5	427.7	-9.8	-2.2%
Non-Recurring Charges	239.8	389.5	149.7	62.4%
Other	4,642.2	4,041.7	-600.5	-12.9%
TOTAL EXPENSES	**57,695.1**	**54,195.5**	**-3,499.6**	**-6.1%**
PRE-TAX NET INCOME	**1,842.0**	**-161.8**	**-2,003.8**	**-108.8%**
PRE-TAX PROFIT MARGIN	3.1%	-0.3%		
PRE-TAX R.O.E	6.9%	-0.7%		

The very next reporting period (1Q90), these "non-recurring" charges recurred. The NFLs continued their net write-offs, totaling $259 million, which again accounted for the bulk of the industry's $487 million quarterly red ink.

A One Quarter Earnings Respite

The only respite from the string of quarterly losses came in 2Q90. The $708 million pre-tax profit posted that period was largely due to the notable absence of any further write-offs. The respite was short lived. The third quarter's post-Kuwait market slide wreaked havoc on firm's securities inventories and led to dried up investor participation. The resultant markdowns of securities to lower market values at September's close and declining investor activity led to another industry loss, $189 million pre-tax, this time distributed among more firms than just NFLs. Specialists, trading and clearing firms, as a group, took enormous write-offs in investments for their own accounts, about $250 million, with equal bottom line losses and similarly sized mark-downs in their investments in affiliates on the balance sheet. The fourth quarter witnessed another resurgence of industry losses, $194 million pre-tax, driven, mainly, by much higher losses at the largest firms – $186 million at the NFLs and $215 million at the LIBs.

NFLs' Woes Continue to Dominate Industry Losses

For the full year also, the industry's $162 million loss was entirely attributable to the NFLs. The NFLs posted a record annual pre-tax loss of $678 million, which was the fourth consecutive annual loss for this group of national retail broker-dealers. The Large Investment Banks managed a pre-tax profit of only $426 million, their lowest annual showing since 1979.

SECURITIES INDUSTRY PROFITABILITY RATIOS

PRE-TAX PROFIT MARGIN
(In Percent)

Firm Category	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
National Full Line Firms	10.9	6.9	8.8	8.6	-0.9	5.6	6.9	-0.9	-0.3	-0.1	-3.9
Large Investment Banks	17.7	15.4	17.4	16.7	11.4	14.6	13.5	4.7	8.4	3.9	2.4
Regionals	14.7	11.1	11.1	12.6	2.6	9.4	11.0	5.5	2.6	4.4	0.4
NYC-Based Regionals	14.7	12.6	14.0	18.3	8.9	12.2	16.1	2.9	7.4	4.2	1.1
NYSE Discounters	17.5	12.2	13.6	14.0	0.3	8.9	15.7	8.6	3.1	7.2	5.8
All NYSE Firms	**14.1**	**10.8**	**13.1**	**12.9**	**5.2**	**10.7**	**11.0**	**2.2**	**4.8**	**3.1**	**-0.3**

PRE-TAX RETURN ON EQUITY
(In Percent)

Firm Category	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
National Full Line Firms	45.0	24.6	29.7	28.1	-2.6	17.9	20.3	-2.1	-0.7	-0.3	-8.3
Large Investment Banks	55.7	56.7	54.8	43.8	31.1	38.5	34.2	9.2	18.2	9.2	5.4
Regionals	N/A	37.2	36.0	40.5	6.8	29.0	32.7	14.0	5.4	10.4	1.0
NYC-Based Regionals	N/A	42.1	43.3	50.7	19.9	31.2	38.3	5.2	15.0	11.4	3.1
NYSE Discounters	N/A	52.2	53.9	46.8	0.8	25.6	49.5	-19.7	5.0	14.5	15.4
All NYSE Firms	**49.2**	**35.9**	**40.5**	**36.6**	**13.3**	**29.4**	**28.6**	**4.7**	**9.6**	**6.9**	**-0.7**

Regional firms, while finishing 1990 with a $32 million Q4 profit after two quarters of losses, still had only a marginal profit of $19 million pre-tax, for the full year, their poorest showing since data became available in 1980. In fact, all groups[3], except Discounters, had their poorest showing on record last year. New York City-Based Regionals and Commission Introducing firms had their smallest profits since records were kept beginning in 1980, while all other firms (not categorized) showed their first annual loss ever as a group.

The NYSE Discounters were the only group of firms not to post a disaster year in 1990; they were also the only group to escape any quarterly losses. Further, the NYSE Discounters' 1990 annual $84 million pre-tax profit would have been much higher if not for Q4's post Kuwait drought in the commission business. Moreover, before Saddam's invasion unnerved investors, Discounters already had $80 million in profits booked (Q1 through Q3) and were headed for their second best year ever.

In fact, much of the Discounters', the NFLs', and the industry's, fourth quarter problems were directly related to investor confidence, or the lack thereof. With investors clearly upset over an announced economic recession, impending war, gyrating oil prices, and crashing bank stocks, commission revenue continued its 1990 quarterly descent, finishing the year with a mere $2 billion posted in Q4. That's the same level of commission business done quarterly from late 1982 to early 1984. For the year, total commissions of $8.9 billion were down 13% from 1989, and 30% below 1987's peak. Commissions also fell to only 15.5% of total revenues in 4Q90.

The NFLs alone, which account for $2 out of every $5 commission dollars earned in the industry, saw their 4Q90 commissions plummet 17% from the previous quarter to under $750 million. This level is merely half of 1Q87's tally for this group, though E.F. Hutton and Thomson McKinnon have merged into other firms in the group since then and Drexel is gone. The latest round of top producing broker wars is an attempt to boost these depressed levels in the current upswing environment, though this tactic usually proves to be very costly in the long run.

February's "Best" Volume Ever

As mentioned, 1991 has gotten off to an excellent start. NYSE average daily volume in 1Q90 is up 26% over the previous quarter (see chart) and February's average daily volume of 227 million shares was the second highest monthly average ever. Considering that the record month, October 1987 (277 million), was built on 600 million share days during crashing markets, February 1991, a *rising* market, is the *best* month ever and many firms have confirmed that it was their best February for the bottom line, even with very slow capital market activity. As the chart below indicates, 1Q91 should show vastly improved industry profitability.

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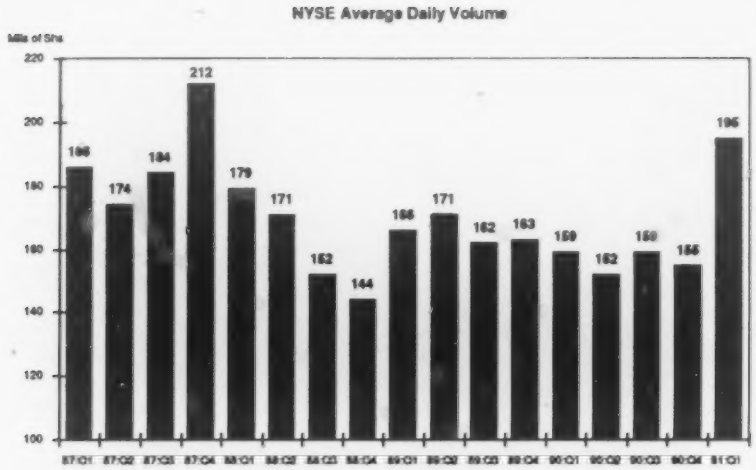
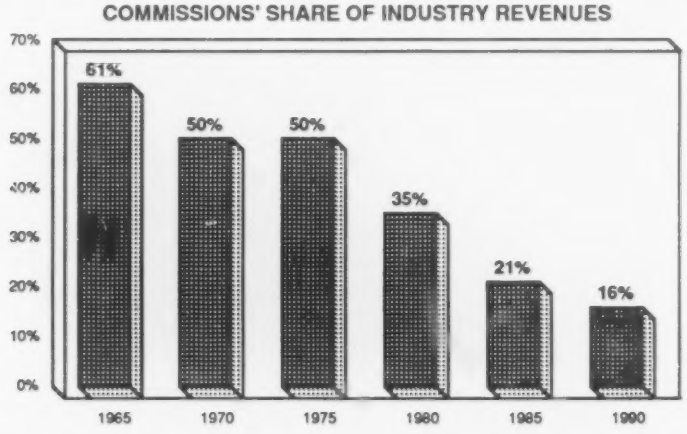
[3] This issue of *Trends* focuses on trends within the securities industry in aggregate. The next issue of *Trends* (May 1991) will analyze these categories of securities firms in more detail.



Still, commissions continue to play a less significant role in the overall revenue picture of the securities industry. Last year, only 16% of total revenues came from the commission business. This was also on a smaller revenue base last year – $54.0 billion, which was $5.5 billion, or 9%, below 1989's record level of $59.5 billion.



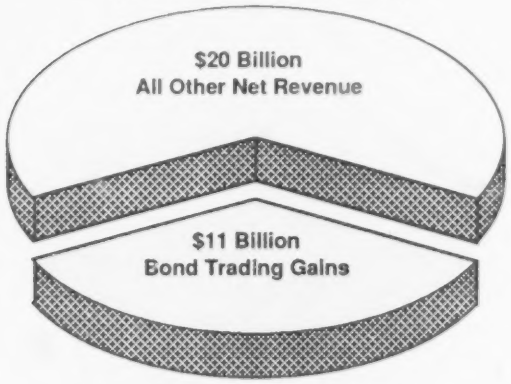
The trend of firms using crossing networks for more and more of their listed equity business is also supported from the 1990 commission revenue results. Agency commissions from sales of listed equity executed away from an exchange skyrocketed 71% last year to a record $147 million, supporting articles showing a trend towards trading being done away from the primary markets.

Principal Businesses

For last year's principal trading, net gains from all trading accounts increased $832 million, or 7%, to a record $13.2 billion. But the year-to-year increase was not equally felt at all firms. Investment banking-oriented firms, such as the Large Investment Banks and the New York City-based Regionals, showed large increases while retail-oriented firms, such as Regionals and the NFLs, showed declines from 1989 levels. In fact, the LIBs' 22% increase in trading gains amounted to a net increase of $832 million, exactly matching the increase for the industry as a whole.

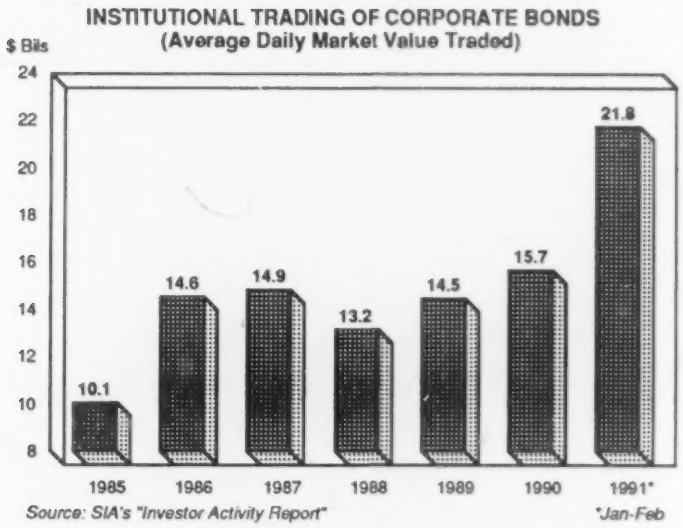
Bond trading, of course, accounts for the vast majority of all trading account gains despite the media's fixation on the equity side such as index arbitrage, risk arbitrage, etc. Last year, 84% of all trading gains came from fixed income, up from 70% the previous year and 60% a decade ago. Bond trading gains, in fact, jumped nearly 30% in 1990 to a record $11 billion, and accounted for 20¢ out of every $1 in total revenue booked; a record share. Furthermore, net of interest, fixed-income trading gains accounted for a record 35¢ out of every $1 of net revenue.

SECURITIES INDUSTRY 1990 NET REVENUE
(Net of Interest Expense)

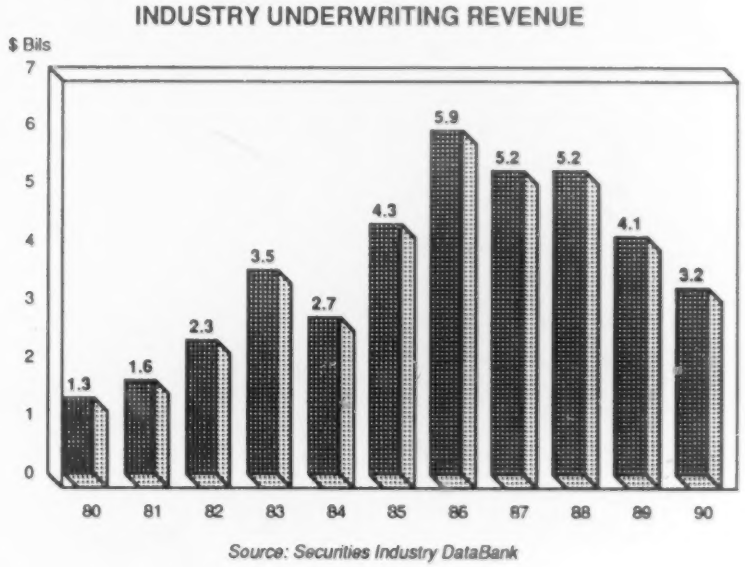


Source: Securities Industry DataBank

The Federal Reserve Board's easing of interest rates begun last summer and continuing into 1991 sent the value of bonds, and the value of trading, skyward. Also helping was the concurrent investor shift of funds from equities to fixed income instruments after the Kuwait invasion in early August. SIA's Investor Activity Report shows that institutional secondary trading of corporate bonds last year reached a record level since data began in 1985. The continued Fed easing in early 1991 led to heavy increases in bond trading. Though debt trading gains are from both corporates and governments, the chart is indicative of the heavy activity in last year's fixed income secondary market.



In the capital markets arena, the 1990s definitely got off on the wrong foot. Industry underwriting revenue fell over 20% last year to the lowest level since 1984, also a tough year. This is merely half of 1986's record showing. The dollar volume of new corporate issues actually set a new high, $314 billion, but this masks the business mix shift which occurred over the past few years.



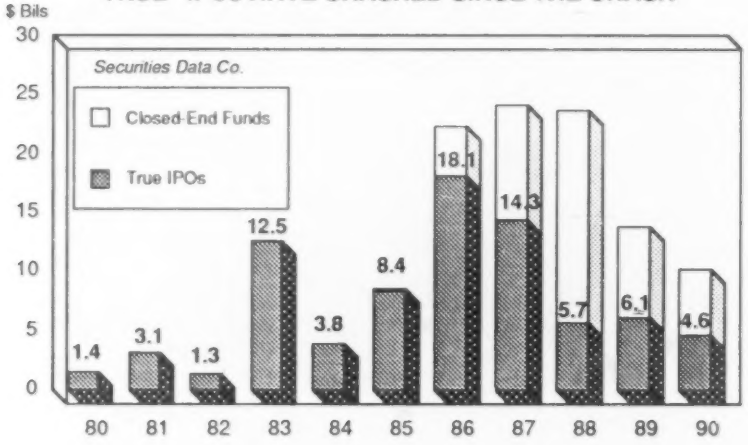
Of the total underwritten last year, $179 billion, or 57%, was in asset-backed debt, the lowest margin business for syndicate departments. Also, Wall Street no longer has a lock on this business. Since the Federal Reserve granted expanded underwriting powers to its charges' "Section 20" affiliates[4], six banks joined 19 securities firms as lead managers of all asset-backed bonds underwritten last year. Furthermore, an additional 34% ($107 billion) of the total came from underwritings of other straight corporate debt, also with very thin underwriting spreads.

There was no good news from the underwritten tax-exempt market either. Municipal bond underwritings have been flat since the Tax Reform Act of 1986 and last year was no exception. With state and local governments across the nation scrambling to close budget gaps due to lower than anticipated tax revenues, exacerbated by further cuts in federal revenue sharing, the immediate prospects look dim despite the pent-up demand for infrastructure rebuilding.

Little IPO Action

Making matters worse, the two "gravy" underwritten products, equities and junk bonds, were practically non-existent last year. Equity underwritings began the year slow and, post-Kuwait, they totally disappeared. The annual total, $24 billion, was the lowest amount of publicly underwritten equity since 1984.

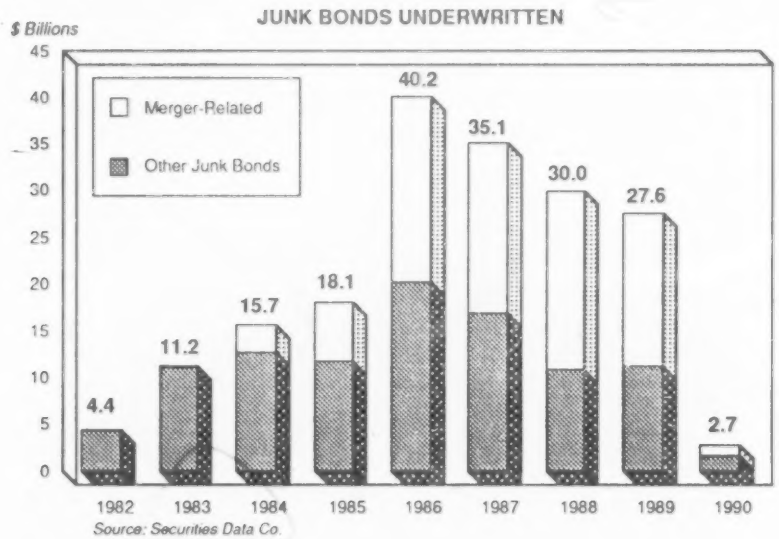
"TRUE" IPOs HAVE CRASHED SINCE THE CRASH



4 The Glass-Steagall Act of 1933 generally prohibits banks which are members of the Federal Reserve System from underwriting and dealing in securities other than U.S. Government and general obligation bonds of states and municipalities (bank-eligible securities). Section 20 of the Act permits banks to be affiliated with firms that are not *principally engaged* in securities activities which are forbidden to the bank itself. Beginning in 1987, the Federal Reserve Board began approving applications by banks to allow these "Section 20 subsidiaries" to underwrite and deal in bank-ineligible securities, including corporate and asset-backed bonds and most recently corporate equity, as long as these activities remained below certain pre-determined thresholds, i.e. not *principally engaged*.

For new companies trying to raise capital via initial public offerings (IPOs) of stock, 1990 was an unqualified disaster. Following two post-crash years of extremely little IPO action, only $4.6 billion in "true IPOs" made it to market last year, again the lowest since 1984. A dual-edged sword was at play. Lack of investor confidence made it nearly impossible to market IPOs while these equity-shy investors, particularly post-Kuwait, sent market levels crashing to multiples that even small companies starving for new capital were reluctant to sell at. The lack of IPOs, the most lucrative deals in terms of underwriting spreads because of the higher associated risks, has sorely hurt corporate syndicate revenues.

Fortunately, 1991's rising market signaled many of these companies, long warming the bench, to get back into the ball game. Although not too many have been able to go to bat as yet because of the delay time in the SEC's registration-to-effectiveness process, line-up at the plate is growing rapidly. Even many of the LBOs of the past are coming back to go public again. The predicted re-equitization of leveraged corporate America is showing signs of getting off the ground.



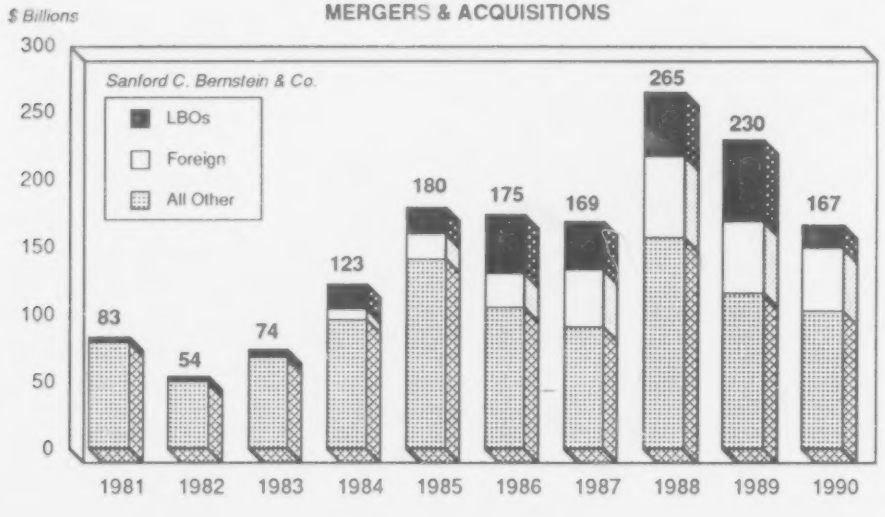
Likewise, the absence of junk bond underwritings, also carrying wider gross spreads, has contributed to the shrinkage in underwriting revenues. After peaking at $40 billion in 1986 during the height of merger-mania in the U.S., junk bond[5] underwritings tapered

[5] Corporate bonds which are rated (or implicitly rated) below investment grade by either Moody's or Standard & Poor's. The vast majority are high-yield straight corporate bonds but also includes some convertible corporate bonds.

off annually until the Fall of 1989 when the market for junk crashed.[6] After Drexel's collapse the following Spring, the junk bond market dried up completely as seen in the preceding table.

Mergers & Acquisitions

The paralysis in the junk bond market had ramifications far beyond just underwriting fees. Much of the merger & acquisition work, particularly LBOs, was made possible by a ready audience for the junk bonds issued to finance these deals. With this option closed off, M&A activity fell by 27% last year. Gone were the most lucrative fees from LBOs and other restructurings, the bridge loan income earned between the M&A fee and the eventual junk bond underwriting fee, as well as other incidental income such as eventual cash outs of gains from pieces of these deals bought by the advisors themselves.



According to Sanford C. Bernstein & Co., 1991 M&A activity should mirror last year's, at least in total volume of completed deals. While it is obviously still early to know the final outcome, Bernstein estimates that the higher equity prices in this year's market will deter LBO and other takeover activity while the higher dollar will dampen some foreign interest as well.

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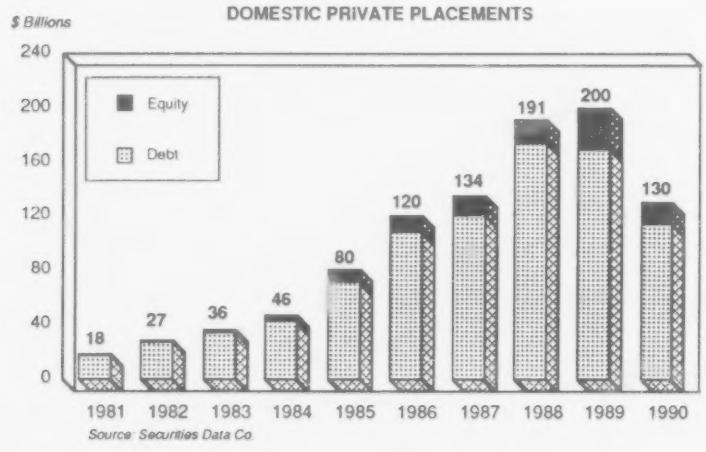
[6] In the Fall of 1989, several companies which had gone through large and well publicized leveraged buy-outs (LBOs) and other merger and acquisition (M&A) deals, mainly fueled from the issuance of junk bonds, could not meet the debt burdens taken on in their LBOs, and the market for their bonds crashed. The wake of these failures shied many investors away from the high-yield market and the resultant lack of demand for junk, the oversupply of junk, and the spreading defaults of junk, basically shut down this market. Also, the Resolution Trust Corp.'s liquidations of the portfolios of failed S&Ls intensified the selling pressure on junk bonds. All of this helped lead to the failure of the top junk bond securities firm, Drexel Burnham Lambert, in early 1990, which in itself shook an already battered junk bond market.

M&A fee income is included in the FOCUS line "other revenue related to the securities business." This revenue line fell by $3 billion or 15% last year. Not all of the drop, of course, was M&A related. Another revenue source included in this line, private placements, also witnessed a contraction by over one-third last year.

Private Placements

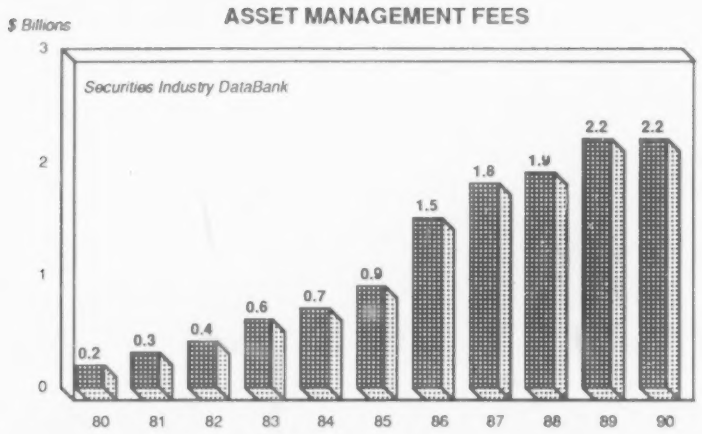
After a decade of spectacular growth, not even stunted by the crash of 1987, the volume of privately placed securities fell by 35% last year As mentioned in the last issue of *Trends*, the three segments previously fueling the post-crash growth – acquisition-related financings, junk bonds and ESOP financings – nearly evaporated in 1990, all down between 50% to 70%. Acquisition-related private placements suffered the same fate as the underwritten junk bond market while the recent, and short-lived, popularity of ESOP-related financings, including private placements, were curtailed by IRS rule tightening.



After reaching a peak of $32 billion one year ago, privately placed equity fell to half that level last year. Even the much heralded Rule 144A, albeit enacted just before 1990's market tanked, was not able to boost the level of private placements, with just under two dozen issuers, half of them foreign, taking advantage of the ruling.

Asset Gathering

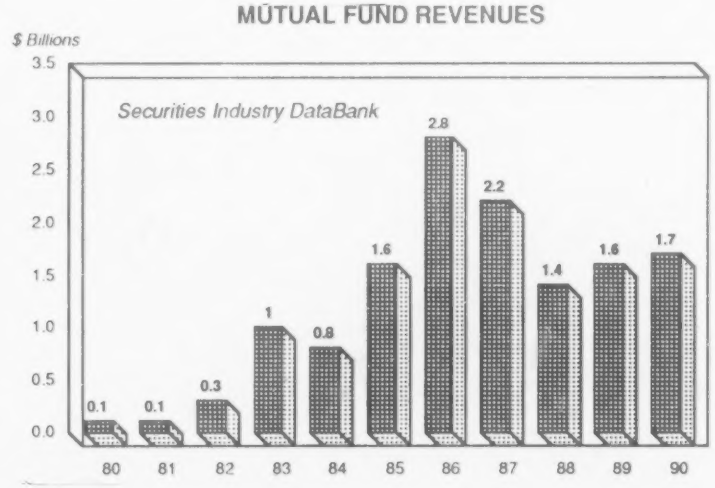
Despite the tough market in the latter half of 1990, one revenue growth area of the Eighties was able to achieve another record showing last year: fees from asset management and account supervision. The $2.2 billion earned from this source last year attained the record by the slimmest of margins – just $15 *million* more than that booked in 1989. Nevertheless, given the nearly across-the-board decreases in other revenue sources last year, the record was a considerable achievement.



The NFLs continue to dominate this business and are, in fact, gaining market share. Their emphasis the past several years on encouraging brokers (and compensating them more) to bring additional, if not all, customer assets in-house, "asset gathering," has helped smooth out some of the cyclicality of the transactional nature of the commission business. In the early Eighties, the NFLs had one-third of the industry's revenue from this source; from 1983 to 1988 they had about a 40% share. The past two years, the NFLs have garnered just over half of all these fees paid to broker-dealers. However, regional retail houses are now getting the asset gathering religion, and one of the newest products generating these fees, "wrap accounts," is now being offered more and more by Regionals.

Mutual Funds

Another area showing steady growth the past few years is the sale of mutual funds. Although revenues are still only three-fifths the peak they reached in 1986, they are still running at a post-crash high and trending up. Again, the NFLs also dominate this business area with approximately 70% of the industry revenues generated from this source. The majority of the balance is earned by Regional firms.



Reduced Repos

While the industry's repo book fell $26 billion, or 9%, in last year's first quarter, the industry financed itself with increased sales of repos throughout the year and Q4's level was up $17 billion over Q1. However, the industry's reverse repo book continued to shrink over the past 18 months, dropping $61 billion, or 24%, from 2Q89 to 4Q90. As mentioned in previous *Trends*, both drops were mainly from the Large Investment Banks which dominate this business and the cutback breaks the trend of a long-term build up of these businesses in the Eighties. Reverse repos grew from $18 billion of assets at the beginning of 1980 to a peak $259 billion at mid-year 1989 before the fall-off to $198 billion at 1990's close. Meanwhile, repos, as liabilities, grew from $21 billion in 1Q80 to a peak $278 billion by 1989's close; they finished at $269 billion in 4Q90.

Interest

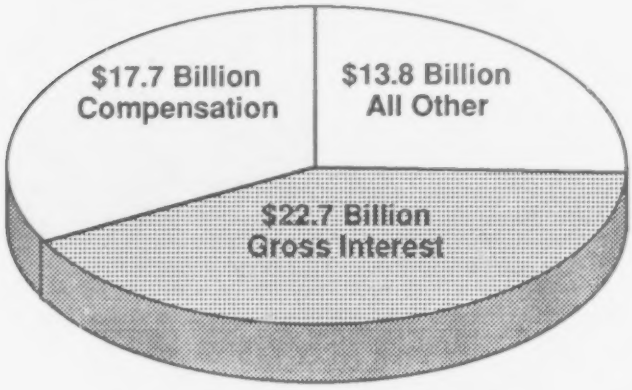
Margin interest steadily provided $3 billion+ in revenues annually the past five years. Nevertheless, last year's margin interest of $3.1 billion was $650 million, or 17%, below the previous year's record $3.7 billion booked. The NFLs, with about half the industry revenues from this source, showed a similar percentage drop as did the LIBs. Discounters and Regionals also showed tail offs in margin interest income but to a lesser degree. Although interest revenue from other sources is not available from FOCUS reporting, the previously mentioned drops in the repo business and the $3 billion, or 15%, drop in "other securities related" revenue (where other interest is booked), is indicative of similar drops in other interest income.

The flip side, interest expense, is available on a gross basis from FOCUS. After a 50% explosion in 1989 from $16 billion to $24 billion, gross interest expense became the industry's largest cost item, supplanting compensation costs' traditional #1 slot. After 1989's initial explosion, gross interest expense tempered somewhat last year, abating just under 6% – $1.4 billion. But since total revenue fell a higher 9% in 1990, gross interest expense's bite out of the total revenue pie rose to a record 42% last year, significantly higher than 1988's 32% bite and double the 21% cut as recently as 1983. The LIBs and NYCs still dominate this expense line, accounting for about 50% and 30%, respectively, of the total industry bill.

Net Interest Income

Of course, looking at just gross interest expense without gross interest revenue, i.e. net interest income (or expense), does not give a clear picture of cost control measures or profitability. On the one hand, most publicly held brokerages, where net interest income figures are available, show positive net interest income. On the other hand, as the industry became more capital intensive, interest expense exploded along with interest revenues and reduced the marginal returns earned from net interest income. Obviously, net interest income is a healthy source of profits, and often a large one, to the bottom line of most firms. Still, managing interest costs closely will be critical for cost controls.

1990 INDUSTRY EXPENSES



Securities Industry DataBank

Compensation Costs

As we've seen, the industry's largest non-interest expense is compensation. For the past two years, compensation was only one-third of all expenses, including gross interest. This compares with an average of 40% to 50% during the Eighties up until the crash. Part of the drop is directly attributable to the explosion in interest and its resultant larger piece of the total expense pie. With this escalating gross interest expense netted out, compensation is still a whopping 56% of net expenses. Still, cost control measures since the crash, particularly headcount related, is having an impact. Prior to 1989, compensation was 60% of net expenses throughout the 1980s.

On an aggregate basis, total compensation paid within the industry fell 6% last year. At $17.7 billion, 1990's payroll bill is down 13.8% from 1987's peak level of $20.6 billion. Still, employment has been trimmed by a higher 19.4% over this same time frame. Actually, immediately after the crash (1988), firms cut employment 8.8% while trimming compensation a close 8.3%. Last year, the cuts were almost as equal, a drop of 5.9% in compensation and 7.8% in employment; 1989 was the lag year when employment fell 4.6% but compensation stayed relatively flat, down only 0.5%.

While the figures are but aggregates across vastly different types and sizes of firms (as well as a shifting universe of firms), they do suggest that there has been some recent reductions in the higher compensated areas of the workforce relative to the back office personnel.

The NFLs made a lot of progress in this area last year. With the concentration of securities industry personnel employed at these firms, the bulk of the layoffs were also concentrated here. Of course, a large part of the reduction came from the previously mentioned consolidation in this group, i.e. Thomson McKinnon and Drexel were no longer in the 1990 data. NFLs' compensation tab fell by 8.4% last year on a workforce reduction of 10.3%, albeit a loss of 12,300 jobs.

Other Costs

As we've already seen, compensation costs fell 5.9% for the industry last year while gross interest expense fell a comparable 5.6%. All other costs, as a group, were reduced 7.0%. While this is a commendable, if not remarkable, progression in the industry's post-crash cost cutting program, profitability still suffered since total revenues plummeted a higher 9.2% in 1990. The only expense line not curtailed last year was "non-recurring charges." As discussed earlier, the heavy write-offs in Q1 drove the 1990 annual totals north by the order of 62%, or $150 million, over 1989's already lofty level.

Otherwise, all expenses were slashed last year. Occupancy and equipment costs fell the least, 2.2%, but are still just a hair below 1989's record cost level. Of course, there is somewhat of a long lag time for cost cutting measures undertaken in this area to flow to the P&L. Previous back-office moves across the Hudson by large New York headquartered firms will begin to show results in future P&Ls while further moves across state lines, some down the entire Eastern Seaboard, will have an impact later in the 1990s.

Total floor costs (commissions and clearance) were trimmed almost 7%. The savings came at the expense of specialists and $2 brokers, who have been under fire to reduce their charges. Floor costs paid to specialists and $2 brokers, about one-third of all floor costs, were shaved 30% last year, or by $226 million. The final tally, $518 million in floor costs paid to these firms, is the lowest total since 1985.

Obviously, with total floor costs down a much smaller 7%, something had to shoot up. Commissions and clearance paid to all other brokers rose $143 million, or 26%, most likely from the number of firms which dropped their self-clearing operations, becoming fully-disclosed correspondent firms.

Meanwhile, communications costs were cut a further 6% last year, to their lowest level since 1985. Other expenses which fell back to 1985 levels are EDP costs and promotional expenditures while losses from errors and bad debts were slashed by 30% to $300 million.

Conclusion

The foregoing expense cuts highlight the serious efforts which were made, with results now showing, in the areas of cost cutting. Part of the expense cuts, without question, are attributable to the shrinkage of the number of firms in the industry with fewer personnel on payroll. Still, the cuts were almost universal. Results of publicly held firms show these cuts at the individual firm level. Further, categories of firms showed an almost across-the-board cost reduction. NFLs and LIBs had expense cuts of 11% and 9%, respectively, last year. Regionals managed a 5% decline, Commission Introducing firms had a 6% cut while unclassified firms (other firms) showed cuts of 3%. Only the Discounters, which had a decent year, and the NYC-Based Regionals, which

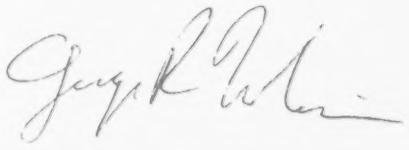
increased in number by one, showed cost increases, but both groups also generated higher revenue last year to offset these increases.

Still with one-third to one-half of NYSE member firms consistently posting red ink each quarter since the "crash," the over-supply, if still there, of the number of securities firms will dwindle further. As mentioned, the number of NYSE member firms last year fell to the lowest ever since records were kept, while the NASD's membership fell to its lowest level since 1984.

Certainly, those firms concentrating on the commission business have seen their prospects do a rapid about face this year. Commission revenue bottomed out at $2 billion in last year's final quarter, the same level as late 1982 to early 1984 and 30% below 1987's peak. Now, first quarter 1991 saw the best commission business in quite a while and the volume on the NYSE was up 26% from the previous quarter. February's volume alone, the second highest daily average, but on a rising market, translates into the *best* month ever in volume with many firms expected to post their best February ever for the bottom line.

Even the capital markets areas, though still slow to date, are receiving signals that some action may soon ensue. As mentioned, 1991's rising market signaled many IPO candidates, long warming the bench, to get back into the ball game. Even many of the LBOs of the past are coming back to go public again. Also, the predicted re-equitization of leveraged corporate America is showing signs of getting off the ground.

Although one quarter does not a trend make, hopefully better markets, less over-capacity in the securities industry, returning investor confidence, and a newly imbedded management philosophy of cost control, will translate into a healthier environment for brokerage firm profitability during the early 1990s.



George R. Monahan
Director of Industry Studies

UNDERWRITING

	FULL YEAR 1990	FULL YEAR 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$314,168.8	$305,518.9	2.8%
Common Stock	$19,225.5	$22,932.7	-16.2%
# of Common Stock Issues	403	474	-15.0%
Preferred Stock	$4,621.9	$7,670.4	-39.7%
# of Preferred Stock Issues	87	108	-19.4%
Corporate Debt	$290,321.4	$274,915.8	5.6%
# of Corporate Debt Issues	1,339	1,371	-2.3%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$95,432.2	$92,325.9	3.4%
# of Issues	4,945	5,374	-8.0%
Competitive	$30,309.4	$29,932.9	1.3%
# of Issues	3,490	3,566	-2.1%

Source: Securities Data Co.

PRICES
(END OF MONTH)

	MAR. 1991	MAR. 1990	% CHG MAR. 1991-1990
DOW JONES INDUSTRIALS	2913.86	2707.21	7.6%
STANDARD & POOR'S 500	375.22	339.94	10.4%
NYSE COMPOSITE	205.30	186.84	9.9%
AMEX MARKET VALUE INDEX	359.20	361.75	-0.7%
VALUE LINE COMPOSITE	237.54	243.87	-2.6%
NASDAQ COMPOSITE	482.30	435.54	10.7%

YIELDS
(MONTHLY AVERAGES)

	MAR. 1991	MAR. 1990	BASIS POINT CHG 1991-1990
BOND BUYER INDEX (20 BOND)	7.10%	7.29%	(19)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	8.93	9.37	(44)
Baa CORPORATE	10.09	10.21	(12)
RATIO Aaa CORPS. TO Baa CORPS.	0.89	0.92	(3)

VOLUME

	FEB. 1991	YTD 1991	FEB. 1990	YTD 1990	% CHG YTD 1991-1990
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	224.9	195.1	155.9	164.2	18.8%
AMEX (MILS.)*	16.6	13.8	13.7	14.2	-3.1%
NASDAQ (MILS.)*	174.9	153.9	127.5	132.6	16.1%
REGIONAL EXCHANGE (MILS.)*	34.9	30.4	25.0	26.5	14.7%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$142,116	$257,880	$99,458	$233,980	10.2%
AMEX (MILS.)	2,801	4,832	2,978	6,769	-28.6%
NASDAQ (MILS.)	56,767	102,142	30,647	73,012	39.9%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.3%	49.8%	51.1%	49.3%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	12,107	23,915	9,764	22,194	7.8%
AMEX OPTIONS	N/A	N/A	2,798	6,553	N/A
COMMODITY	20,605	42,535	22,724	47,894	-11.2%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE